

Recent Developments in Japan's International Taxation

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Background - Domestic Economy

- Demographic changes
 - Decreasing population
 - Rapidly-aging society
- Diversification
 - Family structure & work patterns
 - Corporate structure
 - Investment activities
- Macro-Fiscal conditions
 - Contracting labor force
 - Lowering household saving rate
 - Large fiscal deficit

Background – Globalization

- Widening & deepening interdependence
 - With respect to goods, capital, know-how, etc
 - With rest of the world, in particular, Asia



- Liberalization in trade & capital movement
- Revolutionary IT progress
- End of the Cold War

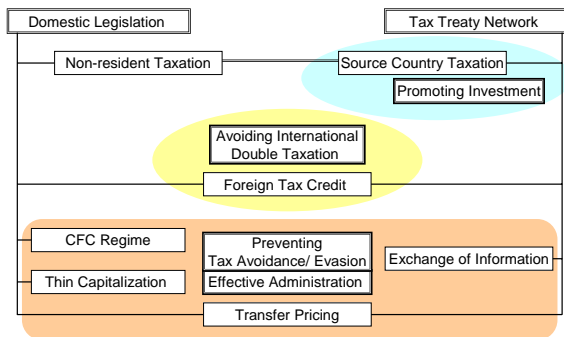
Background – Globalization

- Growth in cross-border transaction
 - E-commerce
 - Services and intangibles
 - Innovative schemes
- Tax competition/ harmonization
 - CIT rate reductions (w/ base broadening)
 - Taxing capital differently from labor?
 - Greater chance of tax evasion and avoidance

Challenges for International Taxation

- Economic revitalization (Japan & Asia)
 - Facilitate mutual investment flows
 - Promote technology transfers
- Fair and neutral taxation
 - Avoid double/ no taxation
 - Properly respond to diversifying business structure & investment activities
- Prevent tax evasion
 - Tax haven/ preferential regime issues
 - Cope with tax shelter, treaty shopping, etc

Japan's International Taxation



History of International Taxation Policy

Japan	OECD
1953 : Foreign Tax Credit	
1955 : First Tax Treaty (Japan-US)	
	1963 : OECD Model Tax Convention
1962 : Indirect Foreign Tax Credit	
	1979 : "Transfer Pricing and Multinational Enterprises" report
1978 : CFC rules	
	1987 : "Thin Capitalization" report
1986 : Transfer Pricing rules	
	1995 : Transfer Pricing Guideline
1992 : Thin Capitalization rules	1998 : "Harmful Tax Competition" report

Topics for Today's Seminar

- Thin Capitalization
 - Basics and Japanese approach
 - General design issues
 - Japanese experience : recent modifications
- Exchange of Information for Tax Purposes
 - Global Forum: global efforts towards "Level Playing Field"
 - Basics: treaty provisions (OECD model)
 - Japanese experience : recent modifications

Thin Capitalization

- One of the major anti-avoidance measures others being:
 - **Transfer Pricing rules** against non-ALP transaction
 - **CFC regime** against retaining earnings in low-tax jurisdiction
- Thin capitalization regime addresses base erosion through thinly capitalized corporation

Thin Capitalization

- Corporation's financing decision:
 - **Debt** : borrowed money
 - Retain ownership or future profits of the business
 - Obligation to pay interest
 - Need to repay principal
 - **Equity** : own money
 - Received in exchange for a share of ownership
 - Better cash flow (no interest)
 - Do not need to repay

Thin Capitalization

- Controlling parent may distort financing decision of its subsidiary only to benefit from different tax treatments
 - **Interest** : deductible
 - **Dividend** : not deductible
- “Hidden equity” or Thin Capitalization

Thin Capitalization : JP regime

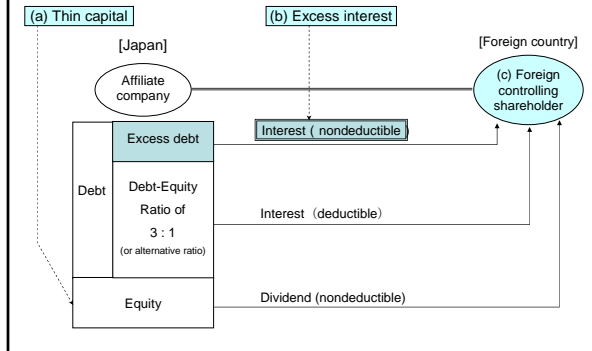
If

- **(a) Thinly capitalized subsidiary** makes
- **(b) Excessive interest payment** to
- **(c) Foreign controlling shareholder**

Then

- Excess portion of such interest payment cannot be deducted

Thin Capitalization : JP regime



Thin Capitalization : JP regime

• (c) Foreign controlling shareholder

- Nonresident entity who
- Directly or indirectly owns
- Controlling share (50 percent or more)

- "Overseas Related Party" as defined in article 66-5 of Special Taxation Measures Law (STML)

Thin Capitalization : JP regime

• (a) Thinly capitalized subsidiary

Both

- Aggregate Debt-Equity ratio and
- Debt-Equity ratio specific to the foreign controlling foreign shareholder

Exceed

- 3 : 1 or
- "alternative ratio": an aggregate Debt-Equity ratio of an independent domestic comparable corporation (of similar size engaged in similar business)

Thin Capitalization : JP regime

NB:

- [Aggregate Debt-Equity ratio] works as “safe haven” (or “safe harbor”)
- 3:1 ratio is relatively generous
 - “Debt” here includes only interest bearing debt
- “alternative ratio” ensure ALP

Thin Capitalization : JP regime

• (b) Excessive interest payment

Excess interest payment is

- The portion of interest paid to the foreign controlling shareholder
- On the debts in excess of the Debt-Equity ratio specific to the foreign controlling shareholder above, which is either
 - 3 : 1 or
 - “alternative ratio” (the same ratio used for (a))

Thin Capitalization: Design Issues

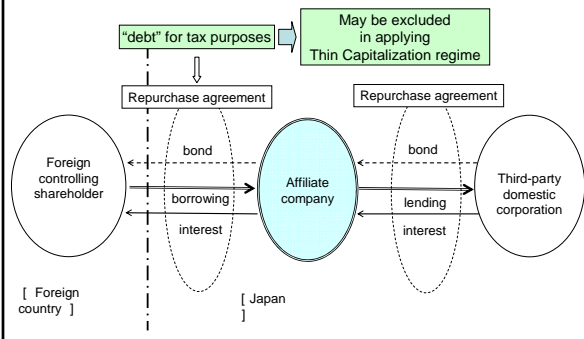
- Controlling shareholder (related party)
 - Foreign and/or Domestic ?
- Safe haven
 - Threshold ratio (1.5:1, 2:1, 3:1)
- Interest covered
 - Guarantee, collateral, ...
 - short-term debt vs. long-term debt
 - Repurchase agreement
- Effect
 - deny deductibility
 - treat as dividend

Thin Capitalization : JP experience

- **Modification to “(a) Thinly capitalized subsidiary”**

- Certain debt may be excluded from the calculation of debt-equity ratio, if
 - the debt originates from a “repurchase agreement” (or, “repo”)
 - “borrowed” money is provided to a third party (economic borrower) through corresponding repo
- If this calculation is elected, the threshold is
 - 2 : 1 or
 - alternative ratio

Recent modification to the definition of “Thin” Capitalization

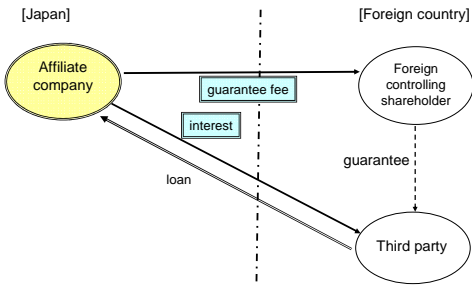


Thin Capitalization : JP experience

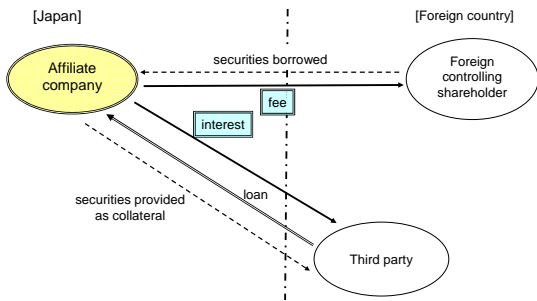
- **Modification to (b) Excessive interest payment**

- For debts provided by an unrelated third party:
 - i) guaranteed by the controlling foreign parent
 - ii) collateralized by securities lent by the controlling foreign parent
 - iii) combination of i) and ii)
- The following payments are treated as “interest” for the purpose of applying Thin Capitalization rules
 - Guarantee fees and lending fees paid to the foreign controlling parent, as well as
 - Interest on such debts
 - Unless they are subject to Japanese corporate income tax

Expansion of interest covered: case i)



Expansion of interest covered: case ii)



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Global Forum:
Global efforts towards "Level Playing Field"

- More than 60 countries and regions are participating in OECD's initiative toward establishing a LPF in tax matters.
- "Global Forum" on Taxation
 - Ottawa meeting in 2002
 - Berlin meeting in 2004
 - Melbourne meeting in 2006

Global Forum:
Global efforts towards "Level Playing Field"

What is "Level Playing Field" (LPF)?

- In the process of achieving **Transparency** and **effective exchange of information** on both criminal and civil taxation matters
- **Fairness**
 - Those committed to the process vs.
 - Those promoting themselves as being outside the process

Global Forum:
Global efforts towards "Level Playing Field"

In order to materialize LPF,

- Individual actions
- Bilateral actions
- Collective actions

in combination are necessary

Global Forum:
Global efforts towards “Level Playing Field”

- Individual actions
 - Modification of domestic laws and practices
- Bilateral actions
 - Implementation of effective EOI for civil and criminal tax matters through a process of bilateral negotiation
- Collective actions
 - Cross-country review of domestic legal and administrative frameworks
 - Convergence of existing practices
 - Involvement of significant financial centers

Global Forum:
Global efforts towards “Level Playing Field”

In particular, a LPF would require

- Strengthened Tax Treaty Network
 - Double Taxation Agreements (DTAs) with EOI
 - Tax Information Exchange Agreements (TIEAs)
- Involvement of significant financial centers
 - Those that are not currently Participating Partners
 - Their commitments in international initiatives are critical

Global Forum:
Global efforts towards “Level Playing Field”

- **Individual actions** to modify domestic laws and practices to ensure:
 - No constraints on international cooperation to counter criminal tax abuses
 - Access to bank information
 - No requirement for DTI (domestic tax interest)
 - Appropriate powers to obtain information for civil and criminal tax purposes

Exchange of Information

Article 26 of the OECD Model Convention

- Scope (tax covered)
- Confidentiality requirements
- Caveat
 - Domestic laws and administrative practices
 - Reciprocity
- No constraint
 - Domestic tax interest (DTI)
 - Bank secrecy

Exchange of Information

Scope:

- The Contracting States shall exchange such information
 - as is “**foreseeably relevant**”
 - for carrying out the provisions of this Convention; or
 - to the administration or enforcement of the domestic laws concerning **taxes of every kind**
 - i.e., all tax matters, civil or criminal

Exchange of Information: Recent modification to Japanese domestic legislation

- Expanded investigation authority of tax inspectors
 - To respond to the EOI requests from treaty partner based on treaty provisions
 - Enabled inquiry and investigation for **all cases**
 - Both **voluntary** and **compulsory** (subject to due judicial process)



- [Before the modification] Did not have the authority to collect information for (their) criminal cases without (our) DTI

Exchange of Information: Recent modification to Japanese domestic legislation

